

Internal Revenue Service
memorandum

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date: July 29, 1991

to: Case Manager, Group 1213, Springfield District
Attn: Rolland Buehrer, Walter Froehling

from: Kenneth W. Wood, Senior Technical Reviewer, Branch 1
Office of Associate Chief Counsel (International)



subject: [REDACTED] -- Affirmative Use of I.R.C. Section 482

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This is in response to your request for informal technical assistance with regard to an issue raised in the course of examining [REDACTED]. The issue is whether a taxpayer may use I.R.C. Section 482 to ensure that its income from licensing intangible property to its foreign subsidiaries is "commensurate with the income attributable to the intangible." The Service's position with regard to this issue is that it is solely the Commissioner's prerogative to make section 482 adjustments. Congress did not intend to change this position by amending section 482 in 1986.

Facts

As we understand them, the facts are as follows. During [REDACTED], [REDACTED], a U.S. corporation, licensed intangible property in the form of proprietary manufacturing processes and other technology to its foreign subsidiaries. The foreign subsidiaries used the intangible property in the manufacture of products. The subsidiaries paid [REDACTED] \$[REDACTED] in license fees during [REDACTED]. Unfortunately, the subsidiaries had significant losses from the sale of products in that year. [REDACTED] now asserts that the license fees were not "arm's length" payments since they were not "commensurate with the income attributable to the intangible," as required by the second sentence of section 482. [REDACTED] claims that the amounts paid should be reallocated to the subsidiaries under section 482.

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Law and Analysis

I.R.C. Section 482 provides as follows:

In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Although the second sentence of section 482 was added in 1986, the remainder of the section has been basically unchanged since it was enacted as section 45 of the Revenue Act of 1928.¹ Section 45 was based on section 240(d) of the Revenue Act of 1924.² Section 240(d) read as follows:

In any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may and at the request of the taxpayer shall, if necessary in order to make an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses, consolidate the accounts of such related trades or businesses. [Emphasis added.]

The 1928 enactment of section 45 altered section 240(d) to remove any reference to the consolidation of accounts, and to eliminate the right of taxpayers to affirmatively use the section to make intercompany allocations. These changes were later memorialized in Treas. Reg. § 1.482-1(b)(3):

Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions.

¹45 Stat. 791, 806, ch. 852.

²43 Stat. 253, 288, ch. 234.

It is not intended . . . to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

Thus, it has been the position of Congress and the Service, since 1928, that section 482 may only be applied by the Service. Treas. Reg. § 1.482-1(b)(3) has been upheld in a number of cases, and may be considered settled law.³

There is one limited exception to the rule that a taxpayer may not affirmatively use section 482. The exception is found in § 1.482-1(d)(3) and § 1.482-2(d)(1)(ii)(b): a taxpayer may offset, against section 482 allocations made by the Service, amounts arising from other nonarm's length transactions between the same entities during the same year as the section 482 allocation.

██████████ agrees that it is the Service's sole prerogative to make allocations under the general provisions (i.e., the first sentence) of section 482. Moreover, ██████████ does not claim an offset under the provisions of § 1.482-1(d)(3). It appears that the amounts paid by the subsidiaries for ██████████'s technology were amounts that an unrelated party, dealing at arm's length, would pay.

██████████ contends, however, that the second sentence of section 482, which was added by the Tax Reform Act of 1986, overrides the other provisions of the section when there is a transfer of intangible property among affiliated entities that is not "commensurate with the income attributable to the intangible." The taxpayer infers that Congress intended to allow foreign corporations to affirmatively use section 482 to decrease royalty payments in a taxable year for intangible property when their income derived from the intangible property was not commensurate with the royalty payments.

³See e.g., Richard H. Foster v. Commissioner, 80 T.C. 34 (1983), aff'd in part and vac'd in part, 756 F. 2d 1430 (9th Cir. 1985), cert. den'd, 474 U.S. 1055 (1986); Richard L. Johnson v. Commissioner, 77 T.C. 837 (1981), aff'd, 720 F. 2d 963 (7th Cir. 1983); OTM Corporation v. United States, 572 F. 2d 1046 (5th Cir. 1978), aff'g, 77-2 U.S. Tax. Cas. 9693, cert. den'd 439 U.S. 1002 (1978); Gulf Oil Corporation v. Commissioner, 87 T.C. 548 (1986); John Ogiony v. Commissioner, 617 F. 2d 14 (2d Cir. 1980), aff'g and rem'g, T.C. Memo 1979-32, cert. den'd, 449 U.S. 900 (1980).

██████████'s contention is not supported by the legislative history of the 1986 Act. The reasons for changing section 482 given by the General Explanation of the Tax Reform Act of 1986⁴ featured the following:

There was a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers could result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.

Congress was concerned that the provisions of sections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not have been operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.

In other words, Congress was concerned that U.S. entities were not receiving adequate consideration for intangible property transferred to foreign affiliates. The "commensurate with income" standard was intended to ensure that U.S. entities were fairly compensated for the transfer of intangible property overseas. It was not intended to be a means whereby foreign taxpayers could decrease the U.S. tax liability of their U.S. affiliates.

If Congress had intended to overturn the settled rule that section 482 may only be used by the Service, this was a very oblique way of doing so. We believe, on the contrary, that Congress intended to add to the Service's tools for ensuring that intercompany transfers of intangible property do not distort the income of U.S. taxpayers. It is not within the jurisdiction of the U.S. taxing authorities to ensure that the income of foreign entities is not distorted when they make royalty payments to related corporations.

As a final remark, we would like to note that the royalty payments made to ██████████ might be considered "commensurate with the income" of the subsidiaries, even though the subsidiaries lost money in ██████████. Taxpayers and the Service should look at more than one taxable year in determining whether a royalty is "commensurate with the income attributable to the intangible." For instance, when a

⁴Prepared by the staff of the Joint Committee on Taxation, May 4, 1987 (U.S. Government Printing Office).

business that is licensing intangible property is in a start-up phase, arm's length royalty payments for use of the intangible property might be greater than the income attributable to the intangible property for several years. In the course of a normal business cycle, however, the income attributable to intangible property is likely to change in a more-or-less predictable way.

Conclusion

A taxpayer may not affirmatively assert section 482 by relying on the section's "commensurate with income" language. The legislative history of the section confirms that only the Service may use section 482 to reallocate income, deductions, credits and allowances among the members of a related group.